Before the

Illinois Commerce Commission

Docket No. 00-0340

ILLINOIS-AMERICAN WATER COMPANY

Rebuttal Testimony and Schedules of

Michael Gorman

On behalf of

Illinois Industrial Water Consumers

Project 7368
October 2000

BAI
BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

**Before the
Illinois Commerce Commission
Docket No. 00-0340**

ILLINOIS-AMERICAN WATER COMPANY

Rebuttal Testimony of Michael Gorman

Q **PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

A Michael Gorman; my business address is 1215 Fern Ridge Parkway, Suite 208; St. Louis, MO 63141-2000.

Q **ARE YOU THE SAME MICHAEL GORMAN WHO PREVIOUSLY FILED TESTIMONY ON BEHALF OF ILLINOIS INDUSTRIAL WATER CONSUMERS (IIWC) IN THIS PROCEEDING?**

A Yes, I am.

Q **WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?**

A I will respond to the rebuttal testimony of Illinois American Water Company (IAWC or Company) witnesses Messrs. Ronald D. Stafford and Paul R. Moul, and the direct testimony of Staff witness William R. Johnson.

Q **PLEASE SUMMARIZE YOUR RESPONSE TO THE COMPANY'S REBUTTAL TESTIMONY AND STAFF'S DIRECT TESTIMONY IN THIS PROCEEDING.**

A My response is summarized as follows:

- Staff's proposed rate design is based in part on district-specific cost of service studies. Staff is recommending a conservative implementation of its cost of service in the Southern division and Peoria district due to significant rate impact on high volume customers in those districts. While I agree with Staff that the Illinois Commerce Commission (ICC or Commission) should exercise caution and concern for the impact on large users in the Southern division and Peoria district, I believe Staff's rate designs are not sensitive enough to these customers' need for competitive rates. Therefore, I recommend the Commission not rely on the Staff's cost of service study and proposed rates for the Southern and Peoria division.

- I recommend the Commission use the Staff's proposed cost of service and rate designs in all districts outside of Southern and Peoria.

- Mr. Stafford has proposed a rate design <u>alternative</u> in which Staff's proposed cost of service study would be used to set rates in Champaign and Sterling districts, and rates would be set using an across-the-board allocation for its single tariff pricing group. I agree, in part, with Mr. Stafford's alternative case, but recommend the Staff's cost of service study also be used to set rates for the Streator and Pontiac districts (IAWC R-1 at 12). He continues to support the Alton source of supply charge, to which I respond below.

- Mr. Stafford has recommended that an across-the-board rate increase be applied in lieu of the Staff's proposed cost of service study in the Southern division and Peoria district in order to mitigate the impact on large users. Mr. Stafford correctly argues that large volume users have competitive choices, and the Staff's proposed rates will cause these customers to seek other sources of water supply. For these reasons, and consistent with the Company's proposal, I support Mr. Stafford's recommendation for the Commission to exercise conservatism in increasing rates in the Southern division and Peoria district, and allocate the appropriate rate increase on a system average basis in the Southern division and Peoria district.

- I respond to Mr. Moul's contention that Staff's and my proposed return on equity is too low in comparison to utility bond yields, and conclude that his argument is unreasonable.

- I provide evidence showing Mr. Moul's contention that Staff's and my recommended return on equity would not provide adequate credit quality for IAWC is unfounded.

- I provide evidence that shows Mr. Moul's criticisms of my DCF analysis and the attendant results are understated and are unreasonable.

- I provide evidence showing Mr. Moul's contention that my CAPM estimate is understated, is unreasonable.

- Based on my response to Mr. Moul's rebuttal testimony, I continue to recommend the Commission set IAWC's return on equity at 10.0%.

<u>Response to Staff Witness Johnson</u>

Q PLEASE DESCRIBE STAFF'S POSITION CONCERNING COST OF SERVICE AND RATE DESIGN.

A Staff has performed cost of service studies for each of the Company's operating districts and single tariff pricing districts. Staff is proposing rates based on its cost of service studies for these districts. Staff witness Johnson has recommended that the Commission not increase the industrial rates in the Southern division and Peoria district to move them all the way to the cost of service produced by his study. Mr. Johnson argues that conservatism should be implemented, and industrial rates in the Southern division and Peoria district should be increased at a level less than necessary to bring those customers to full cost of service.

Q PLEASE COMMENT ON STAFF'S PROPOSED RATE DESIGN.

A I agree with Staff that conservatism should be exercised in developing large volume rates. However, Staff's proposal to increase third and fourth block rates by 2.5 and 1.5 times its proposed average increase in the Southern division and Peoria district is unreasonable. This proposed rate increase is excessive and should not be adopted. Instead, as discussed in detail below, a rate design should be implemented that further mitigates the effect on large volume general service customers.

Q MR. JOHNSON ALSO ADDRESSES IAWC'S PROPOSED STANDBY RATE CHARGES, AND INDICATES THAT IN THE NEXT RATE CASE, IAWC PROVIDE ALL NECESSARY INFORMATION IN ORDER TO DETERMINE STANDBY RATES. DO YOU HAVE ANY COMMENTS? (ICC STAFF EX. 4.0 AT 23).

A I agree that all such information be provided, with one additional request. To the extent possible, I would encourage IAWC to share with Staff and IIWC information on cost and rate design prior to its filing, with the hope of perhaps reaching a consensus before the rate case is actually filed. A dialogue would be beneficial to all, in my opinion. As evidenced by the Commission's Order in the last rate case, the issues surrounding standby rates are fairly complicated. Meetings beforehand may serve to eliminate some or all of the controversy.

Response to IAWC Witness Stafford

Q PLEASE DESCRIBE MR. STAFFORD'S TESTIMONY CONCERNING THE PROPER COST ALLOCATION RATE DESIGN FOR IAWC.

A Mr. Stafford takes issue with the Staff's proposal to rely on its cost of service study to design rates for each of the Company's operating districts. Mr. Stafford rightly argues that there are special circumstances to justify the mitigation of rate increases to the Southern division and Peoria district's large volume users. Because of these special circumstances, the Company is proposing the following mitigation efforts:

1. The Company is proposing an Alton special charge to reduce the rate impact on Southern/Peoria districts' customers outside of Alton.
2. The Company proposes an across-the-board rate increase.
3. The Company is proposing to set fire protection at its cost of service.
4. The Company proposes no reduction to the customer charge in any district.
5. As an alternative, Mr. Stafford is willing to accept Staff's proposed rates and cost of service for its Champaign and Sterling districts, but retain the across-the-board increase for its Southern, Peoria, Pontiac and Streator districts. (IAWC Ex. R-1 at 11-12)

Q PLEASE SUMMARIZE YOUR COMMENTS CONCERNING MR. STAFFORD'S REBUTTAL TESTIMONY.

A IIWC continues to advocate rates designed on the basis of district-specific cost of service studies, which is not the same as Staff's single tariff pricing driven cost studies. However, if the Commission continues to expand the application of single tariff pricing, then there are certain compromises that IIWC will make with Mr. Stafford's <u>alternative</u> position as described in his rebuttal testimony. These compromises are summarized as follows:

1. I agree with Mr. Stafford that it is important to mitigate the increase on large volume users in the Southern division and Peoria district. As discussed below, these large volume users can avail themselves of alternative sources of water for production processes. If the pattern of above-system average increases in the Company's third and fourth water block rates continue, as has occurred over the last ten years, the large volume users will move aggressively to pursue alternative supply options and may leave the IAWC system. Losing customers will detrimentally impact customers remaining on IAWC's system.

2. I can support the use of Staff's cost of service study and proposed rates in the Champaign and Sterling districts consistent with Mr. Stafford's alternative proposal, as well as Staff's cost of service study and proposed rates in the Streator and Pontiac districts. Staff's proposed rates do not create the competitive concerns in Streator and Pontiac districts as they do in the Southern division and Peoria district.

3. I can support Mr. Stafford's proposed across-the-board increase to all rates in the Southern division and Peoria district. This rate design will mitigate the rate impacts on large volume customers in these districts.

4. I continue to oppose the Alton source of supply charge for the reasons expressed in my direct testimony.

Q HAVE YOU PREPARED A SCHEDULE WHICH COMPARES THE RATES IN THE SOUTHERN DIVISION AND PEORIA DISTRICT USING AN ACROSS-THE-BOARD INCREASE COMPARED TO STAFF'S PROPOSED RATES?

A Yes. Using Staff's proposed system average increase in the Southern division and Peoria district of 6.22%, I show what the rates would be under both the Staff's proposed rates and the alternative method of increasing rates under an across-the-board methodology. This is shown on my Exhibit MPG-2, Schedule 1.

Q PLEASE DISCUSS THE SPECIAL CIRCUMSTANCES IDENTIFIED BY MR. STAFFORD FOR USING AN ACROSS-THE-BOARD INCREASE, RATHER THAN STAFF'S COST OF SERVICE STUDY IN THE SOUTHERN DIVISION AND PEORIA DISTRICT.

A At Page 10 of his rebuttal testimony, and as noted above, Mr. Stafford correctly observes that large volume customers have the capability to seek other sources of water supply. He also notes that if these large volume users leave the Company's system, all other customers would pay higher rates. Remaining customers' prices would increase because IAWC's rates would be adjusted to spread the Company's fixed costs over a smaller sales base.

Q IS MR. STAFFORD'S RATIONALE FOR MITIGATING THE INCREASE IN THE SOUTHERN DIVISION AND PEORIA DISTRICT TO LARGE VOLUME USERS REASONABLE?

A Yes. Several of the large volume users that Mr. Stafford has referenced are already using their own well or surface water supplies, in part, for production processes. If the Company's rates become less competitive in relation to alternative sources of water, these industrial companies will have no alternative but to shift more supply away from IAWC. Unnecessarily increasing the cost of water to large volume users will further thwart the economics of production in IAWC's service area and will require an appropriate economic response by these customers.

Q HAVE THE COMMISSION AND ITS STAFF RECOGNIZED THE NEED FOR IAWC'S RATES TO BE COMPETITIVE?

A Yes. The Commission and its Staff supported the Company's development of a large user water service rate in Docket Nos. 97-0102 and 97-0081. The Commission also approved a competitive rate to prevent uneconomic bypass of IAWC's system. These rates were approved to allow IAWC the flexibility to compete with its customers' cost of alternative water supplies.

Q DID THE COMMISSION COMMENT ON THE RATIONALE FOR APPROVING THE LARGE USER SERVICE RATE?

A Yes. In IAWC's last rate case, the Commission, in approving the large user water service tariff, noted the testimony of IAWC witnesses in that proceeding, "that customers eligible for service under the Large User Tariff have a greater incentive to consider alternative sources of supply, given the large quantities of water consumed, and their assertion that retention of these customers and their revenues which they provide to cover fixed costs will benefit all customers" (Order at 26). I submit the sane remains true with large volume users, as well.

Further, in that case Staff did not oppose the concept of the large user tariff, though recommending certain adjustments. Notably, the Commission did take issue with the pricing formula that would, under certain conditions, maintain the rate level even in the event of a rate increase. Specifically, the Commission stated the rate levels and competitive alternatives of this customer class can be addressed in any future rate proceedings to determine whether and to what degree cost increases should or should not be allocated to this class. It would seem, therefore, the Commission left open the possibility of mitigating future rate increases to those customers affected by similar facts and circumstances.

Q **HAVE THERE BEEN OTHER MEANS TO ADDRESS THE POSSIBILITY OF LARGE CUSTOMERS LEAVING THE IAWC SERVICE TERRITORY, DUE TO THE COMPETITIVE PRESSURES MR. STAFFORD IDENTIFIES?**

A Yes. Again in the last rate case, Docket Nos. 97-0102 and 97-0081, IAWC proposed a standby service tariff. As indicated in the Commission's Order, IAWC argued the standby service tariff was necessary, in part, due to competition and the impending development by customers of alternative sources of supply. Once more, Staff agreed with the notion of a cost based standby rate. (Order at 27). In the end, the Commission approved the standby rate recognizing that competition may be increasing for water utilities such as IAWC as Federal clean water standards are implemented and/or raised (Order at 48).

I would also note that standby water rates were previously approved by the Commission in the Northern Illinois Water Corporation Service territory.

Q **WHAT CONCLUSIONS CAN YOU DRAW FROM THE COMMISSION'S PRIOR DECISION?**

A. Clearly, the Commission has acknowledged the competitive pressures on IAWC, and the need to be flexible and innovative in retaining large volume customers. Indeed, soon after the last rate order, IAWC proposed a "competitive rate" whereby customers that were able to demonstrate a viable competitive alternative, and meet other conditions, would be entitled to a fixed price during the term of the contract. While the large user service tariff, standby rates and competitive rates are helpful, there is no denying the fact large volume customers have seen far above system average increases in the third and fourth blocks in recent years.

Given this trend in rate increases in the third and fourth blocks, large volume customers are forced to consider alternatives. These alternatives may include well water supply, revamping existing or abandoned wells, shifting production, or giving new consideration to taking water from the City of St. Louis.

Q DO THE COMPETITIVE RATE LARGE USER SERVICE RATES AND STANDBY RATES ADDRESS ALL COMPETITIVE SITUATIONS?

A No. There are also large volume customers under the Company's general service tariff rates that also have alternative water supplies. Certain of these customers whose annual consumption falls short of 250,000 Ccf do not qualify for the large user service rate. Therefore, in order to retain these customers, IAWC would either have to offer a competitive rate, which would likely be below the current general service tariff rates, or risk these customers leaving the system. Alternatively, the across-the-board increase that I am proposing would reduce the economic incentive to utilize non-IAWC sources.

Q ARE THERE OTHER REASONS THAT YOU WISH THE COMMISSION CONSIDER WITH RESPECT TO YOUR RECOMMENDATIONS?

A The Commission needs to recognize, and I believe it already has, that setting rates in the IAWC service territory may not result in homogeneous rates. The Company's service territory continues to expand with its recent acquisition of Northern Illinois Water Corporation. Now it plans to acquire Citizens Utility Company of Illinois. Assuming this acquisition is approved, IAWC's service territory will extend from near Chicago south to Cario, nearly the entire length of the State.

Given this expansive service territory, and the differing needs and circumstances of ratepayers throughout, it may be difficult to settle on one rate philosophy. For example, the economic situation of customers in southwest Illinois may significantly vary with those in the collar counties, or ratepayers in Cairo. Also, as is true in the Southern division, large volume users have competitive opportunities and choices that may not exist elsewhere. Or, one region may be experiencing significant growth and sales, and rate increases may be more readily absorbed. The point being, a "one size fits all" approach may not be workable.

Q YOU STATED THE COMMISSION HAS ALREADY RECOGNIZED THAT HOMOGENEOUS RATES MAY NOT BE PRACTICAL. CAN YOU ELABORATE?

A The Commission, for instance, has not required single tariff pricing for IAWC's entire rate structure. The Commission has recognized there are material cost differences amongst regions, depending on their source of supply. Further, based on the Company and Staff's cases, it does not appear there will be one consistent rate structure or philosophy for IAWC. IAWC has expressed a willingness to consider Staff's cost of service study in certain districts. Therefore, my recommendation to use the Staff's cost of service study and IAWC's across-the-board approach in the manner proposed, is intended to recognize the disparate needs of ratepayers.

Response to IAWC Witness Moul

Q PLEASE SUMMARIZE MR. MOUL'S REBUTTAL TO YOUR DIRECT TESTIMONY.

A Mr. Moul's rebuttal to my direct testimony is summarized as follows:

1. He maintains my recommended return on equity is too low in comparison to recent utility bond yields.

2. He maintains my recommended return on equity would not provide adequate credit quality for IAWC.

3. He criticizes the comparable group used in my DCF analysis. He maintains I should have eliminated E-town as it is the subject of a current acquisition.

4. Mr. Moul also criticizes my DCF because I did not use Value Line growth estimates.

5. Mr. Moul opines that my CAPM result is understated because my market risk premium is too low.

6. Mr. Moul also argues that my CAPM return is understated because updated beta estimates have increased.

Q PLEASE DESCRIBE MR. MOUL'S CONTENTION THAT THE STAFF'S AND YOUR RECOMMENDED RETURN ON EQUITY IS UNREASONABLE IN COMPARISON TO CURRENT UTILITY BOND YIELDS.

A At Page 2 of his rebuttal testimony, Mr. Stafford maintains that Staff's and my return on common equity is not reasonable because the implied equity risk premium over A-rated public utility bond yields would be 1.77% to 2.37% based on Staff's recommended return range, and 1.87% based on my recommended return on common equity. Mr. Moul argues that this premium to the utility bond yield is wholly inadequate (IAWC Ex. R-7 at 2).

Q PLEASE RESPOND TO MR. MOUL'S CRITICISMS THAT YOUR PROPOSED RETURN ON EQUITY IS TOO LOW IN COMPARISON TO UTILITY BOND YIELDS.

A Mr. Moul's contention that the proposed return on equity in comparison to current cost of the utility's debt is totally inadequate, is wholly unfounded. In his direct testimony, Mr. Moul did provide an equity risk premium analysis, but for the reasons described in my direct testimony, that analysis was severely flawed and produces a significantly over-stated utility equity risk premium.

The equity risk premium proposed by Staff's 10.2% common equity return, and my 10% common equity return, in relation to an 8.13% bond yield, is 2.07%, and 1.87%, respectively. In my judgment, these equity risk premiums are reasonable for a low risk water utility like IAWC.

More to the point, the Staff and I have recommended the use of the DCF and CAPM analyses to measure IAWC's return on equity. These models are sound and the results are reasonable. There has been no credible risk premium model proposed in this proceeding, therefore Mr. Moul's contention should be rejected as unsupported.

Q PLEASE DESCRIBE MR. MOUL'S TESTIMONY SUPPORTING HIS CONTENTION THAT STAFF AND YOUR COMMON EQUITY RETURN LIMIT THE COMPANY'S ABILITY OF OBTAINING REASONABLE CREDIT QUALITY.

A Mr. Moul estimated IAWC's pre-tax interest coverage ratio based on the Staff's and my recommended return on equity. His estimate of the pre-tax coverage ratio for Staff and my recommended returns are 2.81X and 2.77X, respectively. He compares these financial ratios to Standard & Poor's (S&P) pre-tax interest coverage ratio financial benchmarks for establishing utility credit ratings. He observes that S&P's pre-tax interest coverage financial ratio benchmark for a BBB-rated utility in the range of 1.8X to 2.8X, and for an A-rating is in the range of 2.8X to 3.4X. Based on this analysis, Mr. Moul concludes that Staff's and my recommended return on equities are too low because they do not produce sufficient pre-tax interest coverage (IAWC Exhibit R-7 at 2-3).

Q PLEASE RESPOND TO MR. MOUL'S ARGUMENT THAT YOUR PROPOSED RETURN ON EQUITY IS TOO LOW TO PROVIDE ADEQUATE CREDIT QUALITY FOR IAWC.

A Mr. Moul's contention that Staff's and my return on equities are too low to provide adequate pre-tax earnings coverage is erroneous for primarily two reasons. First, his calculation of pre-tax interest coverage ratio is flawed because he only considered the Federal tax at a rate of 35%; he did not reflect IAWC's state income tax included in the Company's revenue requirement. As shown on IAWC Exhibit 7.1, Schedule .1, Mr. Moul demonstrates his pre-tax coverage of interest expense using a Federal income tax rate of 35%. However, as shown on the Company's Schedule C-14, the income tax expense included in the Company's revenue requirement is based on both the Federal income tax rate of 35%, and a state income tax rate of 3.998%. Including Illinois state income taxes would increase IAWC's pre-tax interest coverage ratios.

Adjusting the income tax factor would increase Mr. Moul's estimate of the pre-tax interest coverage ratio, as shown on Page 3 of his rebuttal testimony, for the Staff from 2.81X to approximately 2.9X, and the pre-tax interest coverage ratio under my recommendation from 2.77X to approximately 2.87X. With only this one correction, Mr. Moul's estimate of IAWC's pre-tax interest coverage ratio under Staff's and my common equity return recommendation would increase IAWC's ratio to within S&P's range for an "A" bond rating. Therefore, Staff's and my recommended return on equity would be consistent with an "A" utility bond rating and that of the comparable group.

Second, in assigning bond ratings, Standard & Poor's doesn't only look at pre-tax interest coverage ratio, as Mr. Moul seemingly implies. Another important financial ratio to Standard & Poor's relates to a utility's cash flow. This ratio is particularly significant for capital intensive water utilities.

I estimated IAWC's pre-tax interest coverage ratio and the funds flow from operations (FFO) interest coverage ratio at my proposed common equity return, and I also show Standard & Poor's benchmark ratios for an "A" and "BBB" bond rating for these same ratios (Exhibit MPG-2, Schedule 2).

As shown on this schedule, the pre-tax interest coverage ratio under my proposed return on equity is consistent with an "A" bond rating. Further, IAWC's funds FFO interest coverage ratio under my recommended return on equity, and the Company's proposed depreciation expense, produce a ratio of 3.6X. This FFO ratio is squarely within S&P's range of 3.1X to 3.9X for an "A" bond rating.

For reasons discussed above, both Staff's and my recommended return on equity will provide the Company with adequate credit protection, and represents fair compensation to utility shareholders.

Q PLEASE RESPOND TO MR. MOUL'S CONTENTION THAT E-TOWN SHOULD HAVE BEEN EXCLUDED FROM YOUR COMPARABLE GROUP BECAUSE IT IS THE SUBJECT OF AN ACQUISITION.

A Mr. Moul's contention in this regard is at best incomplete. He states that merger and acquisition (M&A) activity has implications for the dividend yield and growth component in the DCF model (IAWC Exhibit R-7 at 4). However, in his criticism of my DCF analysis, he only proposed to remove the companies included in my comparable group whose dividend yield may have been impacted by M&A activity. Toward this end, he proposed the exclusion of E-town which would increase my DCF result. However, another company included in my comparable group could also be eliminated due to M&A impact on its earnings growth. Specifically, Philadelphia Suburban Company's (PSC) earnings growth has improved due to its acquisitions of other water utilities. Consequently, PSC's earnings growth rate is overstated due to M&A activities. Once PSC's M&A activity slows, and synergies from completed transactions are captured, PSC's earnings growth rate will decline. PSC's abnormally high earnings growth rate would increase my DCF return. Therefore, if Mr. Moul's contention to exclude all utilities impacted by M&A activity is adopted, both E-town and PSC should be removed from the analysis.

If the Commission accepts Mr. Moul's proposal to M&A influenced DCF components, then my DCF return estimate would be reduced from 9.98% to 9.48%, as shown on my Exhibit MPG-2, Schedule 3.

Q WHAT EVIDENCE DO YOU HAVE THAT PSC'S EARNINGS GROWTH IS IMPACTED BY M&A ACTIVITY?

A The positive impact of M&A activities on PSC's earning prospects is evident by a review of the company's own Annual Report to Shareholders, and Value Line's review of the company. In PSC's Chairman's Message to Shareholders, as published in PSC's 1999 Annual Report to Shareholders, he expounds on the company's success in improving earnings and shareholder value through its "growth-through-acquisition strategy" and how it has become a leader in the consolidating water utility industry. The Chairman notes that the company's revenue growth in 1999 improved primarily through acquisitions, and the company anticipates continuing to improve earnings by finding cost reduction activities through acquisitions, and expanding its customer base.

Similarly, Value Line's evaluation of the company also references its acquisitions as having a positive impact on the company's performance. Value Line states as follows:

> "Philadelphia Suburban's operations are performing well. The Company posted net income of $0.33 in the second quarter, buoyed by customer growth from acquisitions, cost control, earlier-than-expected rate case settlement awards.

. . . .

Over the long term, Philadelphia Suburban will have to focus on cost control and continue its acquisition strategy in order to grow earnings."

The above references clearly demonstrate that PSC's current and projected earnings are impacted by its M&A activities.

Q DO YOU AGREE WITH MR. MOUL THAT E-TOWN SHOULD BE EXCLUDED BECAUSE IT IS THE SUBJECT OF A MERGER AND ACQUISITION?

A Not necessarily. E-town's dividend yield component is reasonably consistent with the other companies included in my comparable group. The dividend yield of E-town is around 3.1%, which is lower than the average of the utility group of 3.8%. While E-town's stock price may have been influenced by the proposed acquisition, the dividend yield is not so out of line with the other water utilities that it should be removed from the analysis. Nevertheless, if the Commission finds it appropriate to remove companies whose DCF factors are influenced by M&A activities, then both E-town and PSC should be removed from the analysis. In either case, my DCF analysis remains sound.

Q PLEASE DESCRIBE MR. MOUL'S ARGUMENT ON USING VALUE LINE GROWTH RATES.

A Mr. Moul argues that Staff and I erred by not considering all relevant earnings growth projections in our DCF analysis. He maintains that Value Line is a credible source, and should have been given some consideration.

Q ARE MR. MOUL'S CRITICISMS REASONABLE?

A No. Mr. Moul is critical that we did not rely on Value Line's earnings growth projections in our DCF analysis. However, to the extent investors rely on Value Line, they would consider all Value Line's estimates. Value Line publishes both earnings and dividend growth projections. A DCF growth rate should reflect dividend growth. Earnings growth rates are used as a proxy for dividend growth. While Value Line's earning growth projections are higher than those contained in my DCF analysis, Value Line's dividend growth projections are not. Indeed, the average Value Line earnings growth rate and dividend growth projections for my comparable group are 7.0% and 3.5%, respectively. The average IBES growth rate I used in my analysis was 6.1%. The IBES growth rate is reasonably comparable to Value Line's earnings growth rate, and significantly higher than its dividend rate. Therefore, the IBES growth does not understate Value Line's projections.

Q PLEASE DESCRIBE MR. MOUL'S CONTENTION THAT YOUR CAPM ESTIMATE IS UNDERSTATED.

A Mr. Moul believes that my CAPM estimate is understated because I used a market risk premium that is too low, and I should have used updated Value Line betas.[1]

Mr. Moul maintained that my market risk premium was understated because the implied market return fell in the range of 13.0% to 13.8%, while Staff's estimated future market return is 16.24% (IAWC Ex. R-7 at 18). Mr. Moul's contention here is unreasonable because he has not shown that Staff's market return estimate is either reasonable, nor superior to those implied from my market risk premium analysis. Absent such a demonstration, Mr. Moul's contention is baseless and should be rejected.

[1] Mr. Moul questions my use of the Value Line betas. He states that while my DCF stock prices were taken on August 7, 2000, my Value Line betas were taken from a May 5, 2000 issue, when that issue was updated on August 4, 2000. While the Value Line updated edition was dated August 4, 2000, this publication was not received in BAI's offices until either August 7 or August 8, which was after my rate of return analysis was conducted for my direct testimony.

Mr. Moul also contends that I should have used updated Value Line betas in constructing my CAPM analysis. Mr. Moul's use of updated data, however, is incomplete. Using the updated Value Line betas for American States Water Company and California Water Company would increase my group average beta from 0.55 to 0.57 as Mr. Moul finds at Page 18 of his rebuttal testimony. However, Mr. Moul's update does not reflect the most recent estimate of the future risk free rate. A recent estimate of the risk free rate, produced by the Blue Chip Financial Forecast, suggests my risk free rate estimate would decline from 6.0%, as used in my direct testimony, to 5.9% (Blue Chip Financial Forecast, September 1, 2000 at 2). Using the updated Value Line beta estimates, and the updated risk free rate, my CAPM return estimate remains at 10.1% as shown on the attached Exhibit MPG-2, Schedule 4.

Hence, a complete update of the data used in my CAPM analysis would not change my recommendation.

Q **DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

A Yes.

ILLINOIS-AMERICAN WATER COMPANY

Comparison of Present, Staff Proposed
and Across The Board Rate Increase
Southern Division and Peoria District

Line	Description	Present Rates (1)	ICC Staff Proposed Rates (2)	Across The Board 6.22% Increase (3)
	Customer Charges:			
1	5/8 Inch	$10.50	$11.00	$11.15
2	3/4 Inch	12.50	14.00	$13.28
3	1 Inch	20.50	20.50	$21.78
4	1.5 Inch	45.50	45.50	$48.33
5	2 Inch	70.50	70.50	$74.89
6	3 Inch	135.50	135.50	$143.93
7	4 Inch	225.50	225.50	$239.53
8	6 Inch	445.50	445.50	$473.21
9	8 Inch	710.50	710.50	$754.69
	Southern Division			
	Consumption Charges:			
10	First 30 Ccf	$1.9870	$2.1670	$2.111
11	Next 570 Ccf	1.4500	1.5390	$1.540
12	Next 12,400 Ccf	1.0710	1.2380	$1.138
13	Over 13,000 Ccf	1.0290	1.1200	$1.093
	Peoria District			
	Consumption Charges:			
18	First 30 Ccf	$1.9870	$2.1670	$2.111
19	Next 570 Ccf	1.4500	1.5390	$1.540
20	Next 12,400 Ccf	1.0320	1.1990	$1.096
21	Over 13,000 Ccf	0.8700	0.9620	$0.924

ILLINOIS AMERICAN WATER COMPANY

Rate of Return Adjustment

Line	Description		Amount (1)	Ratio (2)	Cost (3)	Weighted Cost (4)	Pre-tax Weighted Cost (5)	Standard & Poor's Benchmarks A (6)	Standard & Poor's Benchmarks BBB (7)
1	Long-Term Debt	$	170,643,270	55.2%	6.97%	3.85%	3.85%		
2	Preferred Stock	$	627,454	0.2%	6.25%	0.01%	0.02%		
3	Common Equity	$	138,036,412	44.6%	10.00%	4.46%	7.15%		
4	Total	$	309,307,136	100.0%		8.32%	11.02%		
5	Pre-Tax Interest Coverage				(1)		2.87	3.4 - 2.8	2.8 - 1.8
6	Funds Flow Operations Interest Coverage				(2)		3.60	3.9 - 3.1	3.1 - 2.1

Tax Factor 1.602534
S&P Utilities Prespectives June 21, 1999 at 3

Depreciation to Rate Base Factor		5.5%
Rate Base	Ex 12.0	318,491
Depr. and Amort. Expense	Ex 12.0	17,617

(1) Col 5: line 4 / line 1
(2) Col 4: (line 4 - line 2 + 5.5%) / line 1

Exhibit MPG-2 ( )
Schedule 2

ILLINOIS-AMERICAN WATER COMPANY

13 Week Average
Constant Growth DCF Model

Line	Utility	IBES 5 Year Estimated Growth % [1]	IBES Quarterly	13 Week Average Price [2]	Quarterly Dividend [3]	Yields	Constant Growth DCF
		(1)	(2)	(3)	(4)	(5)	(6)
1	American States Water Co.	4.50%	1.106%	29.21	0.320	4.4%	9.16%
2	California Water Service Group	N/A	N/A	23.94	0.275	4.6%	N/A
3	E'Town Corp.	3.00%	0.742%	66.17	0.510	3.1%	6.21%
4	Philadelphia Suburban Corp.	11.08%	2.662%	22.07	0.180	3.3%	14.75%
5	American Water Works	5.85%	1.431%	24.43	0.225	3.7%	9.80%
6	Group Average	6.108%	1.49%	33.16	0.302	3.8%	9.98%
7	Average ASWC and AWW						9.48%

Source: [1] I/B/E/S International, Inc. via the Internet
[2] Yahoo.com, historical stock prices
[3] The Value Line Investment Survey, dated May 5, 2000

ILLINOIS-AMERICAN WATER COMPANY

CAPM Cost Estimate

Line	Description	Historical Premium
1	CAPM	9.9%
2	Rf	5.9%
3	Risk Premium	7.1%
4	Beta	0.57
		Prospective Premium
5	CAPM	10.3%
6	Rf	5.9%
7	Risk Premium	7.8%
8	Beta	0.57
9	CAPM Average	10.1%

Sources: 1) Value Line Investment Survey, dated August 4, 2000
2) Blue Chip Financial Forecast, September 1, 2000

ILLINOIS-AMERICAN WATER COMPANY

Comparable Water Utilities

Line	Utility	Beta
1	American States Water Co.	0.65
2	California Water Service Group	0.60
3	E'Town Corp.	0.50
4	Philadelphia Suburban Corp.	0.55
5	American Water Works	0.55
6	**Average**	**0.57**

Source: The Value Line Investment Survey dated, August 4, 2000